

Some of the Things Every Director of a California State-Chartered Bank Should Know

I. Statutory Duties of a Director

All provisions of laws applicable to corporations generally apply to banks, including the General Corporation Law. Financial Code § 101.

Duties of Directors (fiduciary duty and duty of care) are set forth in Corporations Code § 309.

- Codifies the California business judgment rule.
(establishes a presumption that directors' decisions are based on sound business judgment).
- Duties must be performed in “good faith;”
in the “best interests” of the bank;
- With the care of an “**ordinarily prudent person**”
(director has common sense, practical wisdom and informed judgment)
in “like position” and “under similar circumstances”
including “reasonable inquiry”(duty of inquiry arises only if the circumstances indicate the need therefor)

Liabilities. Performance of Duties Eliminates Liability for Failure to Discharge Obligations as a Director. Refer to Corporations Code § 309(c).

Monetary Damages. Personal Liability for Monetary Damages. May be eliminated or limited by the appropriate provisions in the bank's articles of incorporation as provided for in Corporations Code § 204(a)(10).

Caveat: The **Sarbanes-Oxley Act of 2002 (Sarbanes Oxley Act)** is a recent codification of corporate governance “best practices” and may create new legal duties under state and federal law. **The Sarbanes Oxley Act is applicable to public companies, including banks and bank holding companies.**

II. How DFI Views Directors

The Department of Financial Institutions views directors as an integral part of bank management. When we refer to “management,” we mean both the board and executive officers. It is the primary responsibility of the board to oversee the bank's operations by:

- Adoption of comprehensive policies in various areas to guide management decisions;
- Delegation of authority for actions to board committees and officers;
- Review and approval of all of the actions of board committees and executive management made pursuant to delegated authority;
- Appointment of an audit committee composed of only outside directors, subject to FDIC exemption authority.

The board must always tread the fine line between attempting to micro-manage the bank's affairs, and thereby usurping the authority of its appointed officers, and failing to hold management accountable for implementation of board policies, and administering the bank's affairs in accordance with those policies.

III. Some Basic Corporate Governance Requirements

BANKING LAW, GENERAL CORPORATION LAW, FEDERAL DEPOSIT INSURANCE ACT

- A board must have at least 5 and no more than 25 directors. Financial Code § 680.
- Board meetings must be held at least once per calendar quarter. However, this is a statutory minimum. More frequent board and board committee meetings will generally be necessary to fulfill the director's duties. Financial Code § 683.
- Telephonic board meetings are permitted. Corp. Code § 307.
- Each board is required to appoint an audit committee, composed only of outside directors to whom the internal auditor and outside auditors will report directly. There are exemptions from this requirement, as may be determined by the FDIC, including the following:
 - If an insured bank can show hardship under the criteria of 12 U.S.C. 1831m(g), the FDIC may exempt it from this requirement.
 - If the insured bank has less than \$150 million in total assets or other FDIC minimum, the bank is not subject to 12 U.S.C. §. 1831m. See the "Exemption for Small Depository Institutions" in 12 U.S.C. § 1831m(j).
- Management is responsible for financial statements, internal controls, and an annual independent audit of financial statements is required, subject to the FDIC exemption authority previously referred to. 12 U.S.C. § 1831m.
- "Large bank" audit committees, as defined by the FDIC, are required, among

other things, to have access to the **audit committee's own outside counsel.**

NEW CORPORATE GOVERNANCE REQUIREMENTS

SARBANES OXLEY ACT (Amends provisions of the Securities Exchange Act of 1934 contained in 15 U.S.C. § 78a et seq. Effective July 30, 2002)

Applicability of Sarbanes Oxley Act to Banks. The Act amended Section 12 (i) of the Securities Exchange Act of 1934 to make it clear that the federal banking agencies have the authority to administer and enforce various provisions of the Act applicable to banks which are public companies.

“Public companies” mean all SEC–reporting companies (§ 2(a)).

- Includes banks and bank holding companies which are public companies. Excludes banks which are wholly-owned subsidiaries of bank holding companies and other wholly-owned affiliates of bank holding companies or banks.
- **Each board of an insured bank which is also a “public company” must comply with the additional applicable provisions of the Sarbanes Oxley Act as well as with the Federal Deposit Insurance Act with respect to audits, audit committees, and other financial management requirements.**

“Public Company Audit Committee Requirements(§ 301):

- The audit committee must be composed **entirely of “independent” directors** (“Independence” defined to prohibit the director’s acceptance of any consulting, advisory or other compensatory fees from the company, and being an affiliate of the company, or any subsidiary thereof, subject to the exemption authority of the SEC and federal banking agencies).(**§ 301**).
- The audit committee must be directly responsible for the appointment, compensation, and oversight of any registered public accounting firm engaged by the company.
- The SEC must issue rules requiring **disclosure** of whether a company’s audit committee includes at least **one “financial expert”**(with auditing experience and knowledge of GAAP).(**§ 407**).

The ban on loans to executive officers and directors in § 402 does not apply to FDIC insured banks if the loan, as defined in the Federal Deposit Insurance Act, is subject to the insider lending restrictions of § 22(h) of the Federal Reserve Act.(12 U.S.C. § 375b).

CALIFORNIA CORPORATE DISCLOSURE ACT (Amends §§ 1502 and 2117 of the Corporations Code. Effective Jan. 1, 2003)

- Requires every Corporation to file annually with the Secretary of State a statement including the following information:
 - Names and addresses of incumbent directors;
 - Number of vacancies on the board;
- Requires every “publicly traded company” to file a statement with the Secretary of State including the following information:
 - Name of independent auditor and description of services;
 - Annual compensation paid to each director and executive officer;
 - Description of any loans made to any director at a preferential loan rate.
 - Statement indicating whether any bankruptcy has been filed by corporation executive officers or directors during the past 10 years;

IV. POTENTIAL LIABILITY

Civil Liability (examples)

- **Liability for Unauthorized Acts.** Two key statutes exposing bank directors to personal liability are Financial Code §§ 687 and 688. The first provides the Commissioner the power to bring an action against the bank’s directors for approving an unauthorized distribution under Financial Code Section 642 et seq. The second provides similar power for the Commissioner to bring an action against the directors to recover any loss which resulted from the approval of any illegal loan.
 - Illegal Distributions. Financial Code §§ 687 and 646**
 - Illegal Loans. Financial Code § 688.**
- **Violation of the “anti-fraud” provisions of the federal securities laws;**

- **Violations of the Sarbanes Oxley Act are treated as violations of the Securities Exchange Act of 1934.**

Criminal Liability & Monetary Penalties(examples)

Violations of various prohibited practices provisions covered in Financial Code §§ 3350 et seq. and 3370 et seq., including:

- **Prohibited Loans to Insiders. (felony and monetary penalties) Financial Code § 3376 (Note: The ban on loans to directors and executive officers contained in the Sarbanes Oxley Act does not apply to FDIC insured banks and thrifts that are subject to the existing insider lending restrictions of the Federal Reserve Act).**
- Receipt of gratuity or personal benefit in exchange for a loan from the bank or a purchase or discount of an obligation by the bank; (felony) Financial Code § 3350.
- Falsification of Records, False Statements, False entries in books or records.(felony) Financial Code § 3368.
- Misapplication of bank assets or credit. (felony) Financial Code § 3361.

V. Key Provisions of the Banking Law You Should Be Aware of

A. Organizational Expenses. Financial Code § 406

Financial Code § 406 prohibits the use of funds from subscribers or shareholders for payment of pre-opening noncapital expenditures without the prior approval of the Commissioner. This means that if the bank fails to organize and commence business, or if unnecessary expenses are incurred in the organizational effort, that the directors/organizers are personally responsible for such costs and these costs will not be reimbursed by the bank.

B. Pre-Opening Expenses. Financial Code § 622

A California bank may not issue any “organizational shares”, or any shares in exchange for any note. All shares issued must be fully paid for.

C. Acquisition of Control. Financial Code § 700 et seq.

Owning or controlling 10 percent or more of any class of voting securities creates a presumption of control. Acquiring control without the prior approval of the Commissioner is prohibited. Financial Code § 701

Shares acquired in contravention of the statute are automatically disqualified from voting for a period of 3 years, Financial Code § 710.

D. Legal Lending Limits. Financial Code §§ 1220 & 1221, 1336

Bank's unsecured lending limit, to any one obligor, is 15 percent of its shareholders' equity, reserves and subordinated debt.

Bank's secured lending limit, to any one obligor, is 25 percent of its shareholders' equity, reserves and subordinated debt whether secured by real or personal property.

Financial Code § 1223 defines conditions for securing a loan with personal property. Financial Code § 1227 defines conditions for securing a loan with real property.

Bank's limitation on investing in the securities of any one obligor is 15 percent

E. Bank's purchase or lease of any real or personal property from a director, purchase of any real or personal property from the bank. Financial Code § 3354.

Financial Code § 3354 prohibits the purchase of any real or personal property from a director without the prior approval of the Commissioner.

Financial Code §§ 3355 & 3356 prohibit the sale of bank assets to an insider for less than their fair market value, and the sale of any asset for less than book value unless approved by the full board, and immediately disclosed to the Commissioner.

F. Loans secured by, or made to purchase, stock of the bank or its holding company. Financial Code § 3359.

Financial Code § 3359 prohibits a bank from making a loan secured by the stock of a bank, or its holding company, or for the purpose of purchasing such stock. One common violation of this section occurs when a bank makes a loan to a director for the purpose of exercising a stock option from the holding company.

G. Loans to insiders ("Officers and Directors"). Financial Code § 3372.

Financial Code § 3372 adopts the same rules covering loans to insiders which are contained in the Federal Reserve Regulation "O". In general, most types of loans to executive officers are prohibited. Loans to directors are permissible, but only

when granted on the same terms as regard to cost, availability, and credit quality as those available to the general public.

One key difference between California law and the Federal Reserve Regulation is that Financial Code § 3376 makes the violation of terms of Regulation “O” a felony. Under the terms of Regulation “O” itself, violation brings only the possibility of civil penalties from federal bank regulators.

Note

Please confer with the bank’s legal counsel regarding the provisions of law covered in this presentation.

The Department of Financial Institutions